No. 14559

United States Court of Appeals
For the Ninth Circuit

EMIL USIBELLI and ROSE P. USIBELLI,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF OF PETITIONERS

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BRIEF OF PETITIONERS

OPINION BELOW

The Findings of Fact and Opinion of the Tax Court (R. 43) are reported at T. C. Memo. 1954-84, filed June 30, 1954.

JURISDICTION

On December 19, 1952, the respondent, Commissioner of Internal Revenue, mailed to petitioner Emil Usibelli a notice of deficiency in income tax for the year ended December 31, 1947, of $1,476.69 and penalty under §294 (d)(1) of the Internal Revenue Code of $132.91, and penalty under §294(d)(2) in the amount of $88.60, and on the same date respondent mailed to petitioners Emil Usibelli and Rose P. Usibelli a notice of deficiency in income tax on a joint return for the year ended December 31, 1948 of $5,648.24 (R. 18, 8). On April 13, 1953, pursuant to §272 I.R.C., and within the 150-day period

prescribed by that section, petitioners filed with the Tax Court their petitions for redetermination of said deficiencies and penalties (R. 1, 3, 13). A motion to consolidate the two cases for hearing was filed and granted October 16, 1953 (R. 2). The petitions were heard on October 16, 1953, and the Tax Court entered its decision on July 6, 1954 (R. 2, 48,49). Petitioners filed their petition for review on September 22, 1954, and filed proof of service thereof on September 23, 1954 (R. 2). The jurisdiction of the court rests on §§1141 and 1142 of the Internal Revenue Code in effect prior to the passage of the Internal Revenue Code of 1954 and §§7482 and 7483 of the Internal Revenue Cole of 1954.

QUESTIONS PRESENTED

The sole question involved in this case is whether in determining the net income of petitioners from Emil Usibelli's coal mining operation in Alaska they are entitled to a deduction for depletion in the amount of $5,596.54 for the year 1947 and $8,026.71 for the year 1948. If such deduction is available, there is no basis for application of the penalty determined by the Tax Court for the year 1947 for failure to file and for substantial underestimation of declaration of estimated tax. Petitioners' right to a depletion deduction for these years hinges on whether or not they had an economic interest in certain coal lands in Alaska from which they mined coal for sale to the United States Army.

STATEMENT OF THE CASE

There is no real factual controversy in this case. It was submitted on a stipulation of facts without either party calling witnesses or introducing other evidence (R. 41). The facts may be briefly stated as follows:

The petitioner Emil Usibelli has been engaged in strip-mining coal in Alaska from 1945 to the present time. Petitioners' coal mining operations were conducted on land under the jurisdiction of the Bureau of Land Management of the Department of the Interior of the United States. Petitioners had filed an application for a mining lease in the Territory of Alaska and their application was pending during the years involved herein. Meanwhile, the United States Army had a special permit from the Department of the Interior giving them access to the coal lands and under the permit the Army could arrange for a private operator to strip-mine the coal and sell it to the Army providing a proper bond was posted (R. 26-27). The Army entered into a contract with petitioners under date of July 1, 1946, providing that petitioners were to furnish and deliver coal for Ladd Field, Alaska, from the mine at Suntrana, Alaska. The coal was to consist of 40,000 tons of mine run and 30,000 tons of lump nut. The total amount to be paid petitioners for the coal was $362,500 computed at $4.75 per ton of mine run coal and $5.75 per ton of lump nut coal (R. 27). The Army and petitioners entered into a second contract dated July 1, 1947, covering 45,000 tons of mine run coal, 25,000 tons of lump nut coal,

and 30,000 tons of steam and stoker coal. The amount to be paid petitioners under this contract was $577,000 computed at $5.22 per ton for mine run coal and $6.22 per ton for the other grades (R. 31). Under these contracts, the first of which was to run from July 1, 1946, to June 30, 1947, and the second of which was to run from July 1, 1947, to June 30, 1948, petitioners were specifically granted the right to mine the coal on the lands embraced in the Army permit (Page 1 of Schedule of Supplies, Ex. 3-C). In addition, the Army arranged for its permit to continue until petitioner's lease was available from the Department of the Interior (Ex. 10-J). Petitioners filed the necessary bond as required by the permit (R. 27).

While operating under the first Army contract, on September 3, 1946, petitioners made an application to the Office of Price Administration in Juneau, Alaska, for an increase in the maximum prices for coal produced, and on September 30, 1946, petitioners were granted an increase in the price of mine run coal to $5.47 per ton. This increase was reflected in a modification of the first Army contract under date of October 22, 1946, providing for an increase in the contract price of the coal by $28,800, this amount covering the increase in the price of mine run coal from $4.75 to $5.47 per ton (R. 27).

Petitioners' lease was granted April 1, 1949 (R. 32).

The trial judge, in his memorandum decision denying the petitioners' right to depletion, stated:

"The coal belonged at all times to the United

States Government. Emil was merely employed on an annual basis to mine and load the coal for use by the Army. The coal was never sold. Emil was paid an agreed amount for the work which he performed. The record does not show that his payments depended upon any sales or market prices of the coal but indicates that they depended upon mining costs. The fact that Emil was applying for a lease is immaterial since he was not a lessee during the taxable years. He could mine only limited quantities of coal and the amount could be reduced by the government. The contracts could be terminated by the government under certain circumstances.

"A study of the entire arrangement between Emil and the Army fails to disclose any economic interest held by Emil in the coal in place as would be necessary to entitle him to deductions for percentage depletion."

SPECIFICATION OF ERRORS

Petitioners hereby make the following specification of errors relied upon in this appeal:

I.

The Tax Court erred in finding that under Emil Usibelli's permit and contracts with the Army during the years 1947 and 1948, he was merely employed on an annual basis to mine and load coal for use by the Army; that the coal was never sold; that the entire arrangement between Emil Usibelli and the Army fails to disclose any economic interest held by Usibelli in the coal in place as would be necessary to entitle him to deductions for percentage depletion.

SUMMARY OF ARGUMENT

In his memorandum opinion the Trial Judge actually mentions four different and distinctive reasons for his ultimate determination that petitioners lacked the necessary economic interest in the coal in place that would entitle them to the depletion deduction. These were that the government could limit the amount of coal mined and could terminate the contracts under certain circumstances; that the petitioners were paid an agreed amount for their work and their compensation was not dependent on sales or market prices; that petitioners were mere hirelings or agents and not independent contractors; and that the coal belonged at all times to the government and was never sold. As will hereafter be shown the Judge's reasons and conclusion will not be supported by the law and evidence in this case.

ARGUMENT

The rights of coal stripping contractors to depletion have been generally recognized by the courts. Two limitations have appeared in Rulings or Tax Court decisions but a careful analysis will show that neither is applicable here.

The first limitation is that of cancellation at will reflected in a Ruling of the General Counsel's office issued in 1950 as G.C.M. 26290, C.B. 1950-1, p. 42. That Ruling related to deductions for depletion under §23(m) I.R.C., in the case of stripping contractors in coal mines. The General Counsel's Memorandum states in part:

"For the purpose of facilitating consideration of

the question here involved, a number of the stripping contracts which it is understood are typical of those used in the coal industry have been examined. For convenience, the parties to such contracts will be hereinafter referred to as the coal company and the contractor, respectively. In view of the contents of the contracts examined, it is the opinion of this office that, dependent upon their rights in respect of the properties involved, stripping contractors may be properly regarded as entitled to deduction for depletion in all respects as in the case of other mineral properties. The fact that some of the contracts bear aspects of agency or employment, or that ostensibly the contractor may not acquire legal title to the mineral, does not control. * * *

"It is not the view of this office, however, that the deduction for depletion is to be granted in every case. On the contrary, it seems clear that the allowance is warranted only where, under the agreement between the parties, the stripping contractor obtains a capital interest in the mineral in place and must look to the severance and sale of the mineral for the return of capital consumed in that process. (See G.C.M. 22730, *supra.*) In this respect, it is noted that in some instances contracts may be cancelled by the coal company at will. Under said circumstances, it would appear that the contractor received no binding right to extract the mineral and thus fails to obtain a capital interest therein. Lacking such an interest in the mineral, it follows that the contractor cannot properly claim a deduction for depletion.

"In the opinion of this office, a contract which is terminable by the coal company at will, and which thus fails to vest in the contractor the requisite

capital interest in the mineral in place, is one in which the coal company has an absolute right to cancel at any time without cause or condition. * * *

"One of the contracts examined shows that the coal company reserves the right, without payment of damages, to 'suspend' work indefinitely at any time or from time to time; under another contract, the coal company is given the right, upon five days' notice to the contractor and without payment of damages, to suspend work for an indefinite period; and under a third contract the coal company may suspend operations during such time or times as the company operates at a loss because of the minimum payable to the contractor. Since contracts of this character, despite the power of indefinite suspension provided for therein, do not, except under specific conditions, appear to permit the coal company to dismiss contractors absolutely and substitute others to extract the minerals, it is the opinion of this office that such contracts should not be classified as contracts which may be cancelled 'at will.'

"It is noted further that in some of the contracts the contractor must look for his compensation solely to the extraction and sale of the coal, that in others his compensation is dependent partly upon extraction and sale of the coal and partly upon removal of the overburden and other factors, and that in still others the remuneration payable to the contractor is in no way dependent upon extraction and sale of the mineral . * * * Where, under the tests hereinbefore described, the contract is not terminable at the will of, or upon nominal notice by, the coal company, it is the view of this office that if the contractor must look for his compensa-

tion solely to the extraction and sale of the mineral, he is entitled to deduction for depletion. * * * "

It is quite clear that in the instant case this limitation is not applicable. The rights of the Army in the coal lands were first granted to continue until six months after cessation of hostilities in World War II. They were later extended to continue until Emil Usibelli's lease was available. Under his contracts with the Army, Emil Usibelli had all of the rights in the coal lands that the Army had. It is true that decision "N" dated August 15, 1947 (Ex. 10-J) provides "the Army has indicated its willingness for the permit to be cancelled when such cancellation is in the interest of the government." But decision "N" goes on to provide immediately following, "It appears that the parties in interest desire the permit extended as specified herein, in order that no time may elapse between the expiration of the permit and the issuance of a coal lease under application, Fairbanks 06561." Fairbanks 06561 was, of course, Emil Usibelli's application for a lease of the coal land (R. 30).

An examination of the contracts between Emil Usibelli and the Army quickly indicates that the contracts were not ones in which the Army had an absolute right to cancel at any time without cause or condition. Again it is true that Article 8 of the first contract (Ex. 3-C) and a comparable provision of the second contract provide in part "The performance of work under this contract may be terminated by the government in accordance with this Article in whole, or from time to time in part, whenever the contracting officer shall determine any such termination is for the best interest of the Gov-

ernment." But Article 8 then goes on to provide that except for a general termination or termination because of war end "such termination shall only be made in accordance with the provisions of this article, unless the contracting officer finds that the contractor is then in gross or willful default under this contract." Then in paragraph (2) of Article 8 the contract provides what the contractor should do in the event of notice of termination, and paragraph (3) goes on to provide for possible agreement by the contractor and the contracting officer for the measure of compensation resulting from the termination including a reasonable amount for profit, and paragraph (4) provides that in the event of the failure of the contractor and the contracting officer to agree as to the amounts to be paid to the contractor by reason of the total or partial termination of the work, then the government shall pay the contractor a schedule of varying amounts which are set forth in detail. Even the somewhat unilateral termination provisions of Article 18 and its counterpart in the second contract are limited by their own terms to the situation wherein the consuming point is abandoned or consumption thereat is reduced or burning equipment is altered or the government should find itself with an excess of surplus from storage at other installations and should desire to ship this surplus to the consuming point.

None of these rights are equivalent to the right of termination at will on the part of the government. At most they qualify as rights of termination under conditions which are specifically stated and are specifically limited.

The second limitation on the rights of coal stripping contractors to depletion is one that has developed in a number of Tax Court decisions, and it is apparent from the decision of the Trial Judge in the instant case that this limitation is the basis of his opinion herein. A succinct analysis of all of the decisions he cites shows that in them the Tax Court has denied a coal stripping contractor a depletion deduction where he is paid under his contract a set amount per ton mined and where his compensation is in no way a percentage of the ultimate selling price of the coal or measured in any appreciable way by the ultimate selling price of the coal.

The first case cited is that of *Helvering v. Bankline Oil Co.,* 303 U.S. 362, which has been recognized in a number of decisions as authority for the premise that "economic interest" does not embrace a mere economic advantage derived from production through a contractual relation to the owner by one who has no capital investment in the mineral deposit. Judge Murdock has, by lumping it with the other decisions he cites, read into this decision a requirement that a coal stripping contractor must, in order to be entitled to depletion, have some market price risk in his activities.

The next case cited is that of *Morrisdale Coal Mining Co.,* 19 T.C. 208. In effect, in the *Morrisdale Coal Co.* decision, the court found that the independent contractors were mere agents of the operator petitioner, performing the service of strip-mining the coal for a stated amount per ton produced, which amount had no relationship to the market price of the coal and no relationship to the ultimate selling price of the coal. In other

words, the court found that the independent contractors were merely performing services for the operator petitioner, and under these facts, the independent contractors had no economic interest in the coal produced, and for that reason, no depletion deduction was available to them.

The next case cited is that of *James Ruston,* 19 T.C. 284. The *Ruston* case involved contracts wherein the strip-mining contractor was to receive not a stated sum per ton mined, but rather was to receive 83% of the net selling price of the coal produced. The coal was to be sold by the operator, but the strip-mining contractor participated in such sale to the extent of 83% of the net selling price after deduction of a selling commission of 15c per ton. The court in the *Ruston* case referred to decisions where the person performing the mining or drilling operation was merely a "hireling"—a person engaged to perform services at a set amount per ton produced—and held that these cases were not applicable where under the facts involved the strip-mining contractor actually shared in the ultimate selling price of the coal. The court pointed out that in the *Ruston* case the strip-mining contractors were required by the contractor to take risks as to what the ultimate selling price would be, because they had to look to the ultimate selling price of the coal before receiving their compensation for the services rendered. The court held in the *Ruston* case that under the facts involved, the strip-mining contractor held an economic interest in the coal in place, and since its income, the 83% of the net selling price of the coal, was from the severance and

sale of the coal, such income is subject to the percentage depletion allowed by the Internal Revenue Code.

The next case cited is that of *J. E. Vincent,* 19 T.C. 501. In the *Vincent* case, the court thoroughly analyzed and distinguished the *Morrisdale* decision and the *Ruston* decision as follows:

> "In *Morrisdale Coal Mining Co.,* 19 T.C. .... (November 12, 1952), we held that the respondent erred in excluding from a mining lessee's income from coal properties the amounts that it paid to strippers under several contracts. The contracts there under consideration were generally similar to that between Gregory Run and Summit Fuel in that under them the stripping contractor was engaged to strip-mine coal from designated tracts, and to haul and load it into railroad cars at specified points. For such services, the stripping contractors were to receive a specified amount per net ton of coal-strip mined and loaded into railroad cars. * * *
>
> "Upon examination of the several stripping contracts in the *Morrisdale Coal* case, *supra,* we concluded that none of them granted to the stripping contractors an economic interest in the coal in place, and for that reason no apportionment of the gross income from the property was to be made between the employing contractor and the stripping contractor. In that case, analyzing two of the stripping contracts, we said in part:
>
> " 'Most of the cases in which depletion has been allowed to an independent contractor have involved situations where the producer or miner of the mineral or other depletable asset has received payment either in kind or as a percentage of the ultimate selling price or profit derived from the sale of the

commodity. *Spalding v. United States* (C.A. 9, 1938), 97 F.(2d) 697, *certiorari* denied 305 U.S. 644 (1938); cf. *Edward J. Hudson,* 11 T.C. 1042 (1948), affd. (C.A. 5, 1950) 183 F.(2d) 180.

" 'Neither of such situations is present in the instant case. The independent contractors received a stated amount per ton for coal of good merchantable quality satisfactory to petitioner. The amount they were to receive per ton was not dependent upon the market nor upon the price petitioner received upon the sale of such coal. Payment was made at stated intervals provided in the contract and was entirely independent of whether or when petitioner sold the coal. The contractors assumed no risk as to the market price, they received no payment in coal, and they had no right to sell any coal to other parties.'

"The factors mentioned in the above quotation exist in this case. Summit Fuel was not to receive payment in kind or as a percentage of the selling price or proft; it was to receive a stated price per ton of coal; payment was to be made at stated intervals and was independent of whether or when Gregory Run sold the coal.

"The case of *James Ruston,* 19 T.C. ...... (Nov. 21, 1952), is distinguishable on the facts. In the *Ruston* case, the lessee of coal property contracted with a strip-mining contractor for the mining, loading and shipping of the coal. * * * The contractor was to furnish at its cost and expense all materials, tools, machinery, equipment, and labor, to build all necessary roads, to make all necessary improvements incident to its operations, and to maintain and keep in proper repair and working order the tipple, screens, loading ramps, sidings, etc., on the property, and to screen, produce, load,

clean, and ship the coal at its own expense. * * * The lessee had the right to sell the coal, but it was provided that the interest of the contractor 'in coal produced and shipped shall be 83 per cent of the net selling price' of the coal as received by the lessee, less a selling commission of 15 cents per ton to be deducted from the gross selling price. * * *

"On the facts in the *Ruston* case, outlined above, we concluded that by the contract between the parties the lessee transferred to the stripping contractor an economic interest in the coal in place which entitled the stripper to percentage depletion on its gross income from the severance and sale of coal. The rights, duties and liabilities of Summit Fuel Company were so far different from those in the *Ruston* case as to require a different conclusion as to the relation of the stripper with the lessee of the coal lands. We think the relation of Gregory Run Coal Company and Summit Fuel Company was simply that of employer and employee, which gave the employee no more than an economic advantage derived from production rather than an economic interest in the coal."

The next case cited is that of *Helen C. Brown,* 22 T.C. No. 8. In this case the coal stripping contractor was compensated on the basis of a percentage of gross sales, and the Tax Court, following the decision of the *Ruston* case, held that the contractor was entitled to depletion.

The final case cited is that of *Mammoth Coal Co.,* 22 T.C. No. 73. Here the court found that the stripping contractor was paid a fixed amount per ton which was in no way contingent upon the selling price of the coal and followed the *Morrisdale* and *Vincent* decisions.

In the instant case the Trial Judge found that the coal

stripping contractor was merely employed on an annual basis to mine and load the coal for use by the Army; that the coal was never sold; that the contractor was paid an agreed amount for the work which he performed; and that his payments were in no way dependent upon any sales or market prices of the coal but that they were dependent upon mining costs . He then went on to determine that the contractor did not have the necessary economic interest that would entitle him to deduction for percentage depletion. It is obvious that he put this contractor in the category of the *Morrisdale* and *Vincent* decisions rather than the *Ruston* and *Brown* decisions.

It is submitted that the Trial Judge's decision is both factually and legally in error. Under the evidence in this case it is apparent that Emil Usibelli was not compensated on the basis of a stated amount per ton of coal produced. He actually sold the coal to the Army under *bona fide* contracts at negotiated prices. The prices per ton varied with the type of coal produced. The prices varied from year to year. The contract price for the year 1947 was subject to O.P.A. control and application had to be made to the Office of Price Administration for approval of the modification in selling price that was negotiated and consummated under modification No. 1 dated October 22, 1946. It is likewise clear that Emil Usibelli was not a hireling or agent under his contracts with the Army. If there was no sale involved and if a hireling or agency relationship existed, there would have been no necessity for petitioners going to the O.P.A. for the allowance of an increase in price.

Practically every provision of the contract is inconsistent with the position that no sale was involved or that an agency relationship existed between petitioner and the Army. Article 1 of the contract providing for the furnishing of coal at prices specified in the schedule of supplies for a stated consideration of $362,500.00 is inconsistent with the position that no sale was involved or that an agency relationship existed. Article 2 providing for payments demonstrates this inconsistency. Article 3 providing for inspection, sampling and acceptance or rejection demonstrates this inconsistency. Article 4 providing a penalty for excess ash content demonstrates this inconsistency. Article 8 providing for termination at the option of the Government demonstrates this inconsistency. This is especially shown by the provision of Article 8, Section (b) providing that in the event of termination the contractor is to "assign to the Government, in the manner and to the extent directed by the contracting officer, all the right, title and interest of the contractor under the orders or subcontracts so terminated." And the same paragraph, providing that in the event of termination contractor shall "transfer title and deliver to the Government in the manner, to the extent and at the times directed by the contracting officer (i) the fabricated or unfabricated parts, work in process, completed work, supplies and other material produced as a part of, or acquired in respect of the performance of, the work terminated in the Notice of Termination." The provisions in the last paragraph of Article 8, Section (d), providing that "Except for normal spoilage and to the extent the Government shall have otherwise

expressly assumed the risk of loss, there shall be excluded from the amounts payable to the contractor as provided in paragraph d(1) and paragraph d(2)(i), all amounts allocable to or payable in respect of the property, which is destroyed, lost, stolen or damaged so as to become undeliverable prior to the transfer of title to the Government or to a buyer pursuant to paragraph (b)(7) or prior to the 60th day after delivery to the Government of an inventory covering such property, whichever shall first occur,'' demonstrate the inconsistency.

The provisions of Article 9 on anti-discrimination and Article 10 on disputes and Article 11 on convict labor and Article 12 on delays and damages and Article 13, notice to the Government of labor disputes, and Article 14, assignment of rights, and Article 15, taxes, and Article 17, changes in destination, and Article 18, variation from quantities specified, and Article 19, price adjustments, and Article 20, delivery, and the provisions of the schedule of supplies showing f.o.b. shipments subject to inspection and acceptance at destination, and showing the analysis on which award is made providing for moisture content, ash content, B.T.U. minimum, all demonstrate this inconsistency. As a matter of fact the extensive activities reflected in the equipment and expense schedules in petitioners' tax returns (Ex. A and B) demonstrate this inconsistency.

It is submitted that a sale was involved and the coal stripping contractor was more than an agent, and the principles of the *Ruston* and *Brown* decisions justify

depletion allowance here even under the limitation written into the right to depletion by the Tax Court.

However, there is another basis which would justify this court's reversing the Tax Court in the instant case, and this will probably be covered more in detail by a brief *amicus curiae* which undoubtedly will be filed herein if approval is granted. The taxpayer in the *J. E. Vincent* case appealed the decision of the Tax Court to the U. S. Court of Appeals for the Fourth Circuit. That appeal together with a number of other appeals involving the same issue was heard in a case entitled *Commissioner of Internal Revenue v. Gregory Run Coal Company,* 212 F.(2d) 52. The United States Court of Appeals for the Fourth Circuit reversed the decision of the Tax Court in the *J. E. Vincent* case on the question of depletion allowance for the coal stripping contractor. The court stated:

> "We think the right of the strippers of the coal in these instances to share in the statutory depletion allowance is established by the decision of the Supreme Court in *Burton-Sutton Oil Co. v. Commissioner,* 328 U. S. 25."

The court went on to analyze the decision cited and then said:

> "We see no material difference between the right of the producer of the oil in the cited case to a depletion allowance and the right of the miners of the coal in the instant case to such an allowance. The fact that in the cited case the amount of the compensation of the producer was a specified percentage of the proceeds of the product, whereas in the pending case the compensation of the producer was fixed by the selling price of the coal,

adjustable to changes in the market, is not significant; nor is it of importance that in the one case the producer also sold the product whereas in the other the sale of the coal was in the hands of the assignor of the contract. In both cases the depletion was dependent upon production and in both the possibility of profit from the use by the operator of his rights over production was dependent solely upon the extraction and sale of the product and gave him an economic interest therein. As was well said by Judge Watkins in *Eastern Coal Corp. v. Yoke,* D. C. N. D. W. Va., 67 Fed. Supp. 166 (46-2 U.S. T.C. par. 9340), 'Irrespective of conveyancing formalities, one who has a right to share in coal produced, also has a corresponding interest in the coal in place.' See also *Spaulding v. United States,* D. C. S. D. Calif., 17 Fed. Supp. 957."

CONCLUSION

Under the law and evidence in this case petitioners had an economic interest in the coal in place which entitled them to percentage depletion on their gross income from severance and sale of the coal.

Respectfully submitted,

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